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AVOIDING A NEW EUROPEAN DIVIDE

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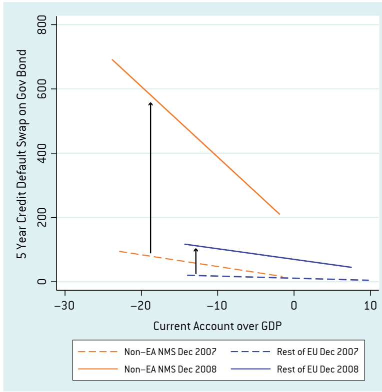
SUMMARY The financial crisis, which is now hitting the new member states severely, highlights the shortcomings of the existing institutional architecture in Europe. Current strains reflect a revaluation of risks but they also result from policy mistakes. For many years, growth in the new member states has relied on massive inflows of foreign capital that are now being called into question. Some of the non euro-area new member states suffer from serious vulnerabilities, to which policy has been slow to respond. Crisis management in the euro area has also had the unintended consequence of putting non euro-area new member states at a disadvantage. These are unhealthy developments and without decisive action, a new political and economic divide within Europe may emerge.

POLICY CHALLENGE

In the short run, the ECB should provide temporary currency swaps to non euro-area new member states. It should also consider accepting non-euro denominated government bonds as eligible securities for its repurchase transactions. In the medium run, proper enforcement of the EU single market and competition rules will be of major importance in maintaining the integrity of the European single market and more effective surveillance is also needed. The EIB and the EBRD should also increase their lending to new member states. Countries in fixed exchange-rate systems in need of real exchange-rate adjustment should if possible build social consensus to cut nominal wages. More fundamentally, policy-makers in the euro area cannot afford to overlook the consequences of their actions for neighbouring countries.

Cost of insurance against government default and the current account



Source: see Figure 3.

A CRISIS REVEALS FAULT LINES in the apparently most solid institutions. This has been the case for private institutions and is also true for public ones, including the EU itself.

Since autumn 2008, the highly successful and seemingly smooth process of integration, growth and catch-up of the new EU member states of central and eastern Europe is suddenly looking more fragile. Crisis and severe adjustment in Hungary and Latvia have highlighted the more general issue of the stability of the region's economies. And the asymmetry between the countries who benefit from the shelter effect of the euro and those who do not in broad terms reinforces the divide between the two parts of the EU.

The management of the crisis in both parts of the EU involves the risk of economic and political tension. Since events took a turn for the worse in September, euro-area crisis management has often been perceived in central and eastern Europe as biased towards the interests of the financial institutions and the economies of the euro area. But, for their part, euro-area observers often highlight the vulnerabilities the non euro-area new member states have accumulated and perceive their policy responses to the crisis as inappropriate or inadequate.

Looking ahead, the emergence of a new economic and political divide within Europe has become a distinct possibility. This risk is not currently being heeded.

An accurate diagnosis entails distinguishing between perception and reality – even when, as here, data is scarce. In what follows, we start with a short recap of crisis developments in Europe. Section 2 deals with the channels of transmission of the crisis. Section 3 assigns responsibilities. Section 4 offers policy recommendations. Section 5 concludes with some broader issues raised by the crisis.

1. CRISIS DEVELOPMENTS: FROM DECOUPLING TO BEING 'IN SYNC'

For a time, we saw decoupling at work within Europe. The financial crisis initially affected the advanced economies of western Europe but had little direct effect on the emerging economies of central and eastern Europe. Things have changed since mid-September, however, and the crisis now threatens to hit the newer EU member states much more than the older ones.

In the advanced economies of Europe, the crisis began in August 2007 with the drying up of liquidity in money markets and lingered for a year until it took a turn for the worse following the collapse of Lehman Brothers in September 2008.

The crisis in the new member states developed differently. Until September 2008 the region – like other emerging countries – did not experience any major turbulence, partly because banks in the new member states had negligible toxic assets and financial innovation was scarce. This was remarkable as many countries in the region exhibited significant macroeconomic imbalances (Table 1). Only Latvia suffered considerable

Table 1

Financial integration and main macroeconomic indicators of the CEE members of the EU

	CA, 2002-07	Net FDI, 2002-07	Credit growth, 2002-07	Foreign bank ownership of banks, 2005	Share of foreign currency loans, 2007	Inflation, 2002-07	Budget balance, 2002-07	GDP growth, 2002-07
Latvia	-14.4	4.8	44.3	53.2	86.3	5.8	-0.9	9.1
Estonia	-12.3	6.9	32.7	99.2	80.0	3.9	2.0	9.0
Bulgaria	-11.1	11.6	33.8	73.0	50.1	5.9	1.4	5.9
Lithuania	-8.6	3.4	41.4	92.0	54.8	2.1	-1.2	7.8
Romania	-8.3	6.0	46.2	63.0	54.3	11.7	-1.8	6.2
Hungary	-6.9	2.5	16.7	82.0	57.1	5.3	-7.5	4.0
Slovakia	-5.5	7.5	8.4	97.4	20.4	4.7	-3.7	6.1
Czech Republic	-4.2	5.4	10.2	93.4	12.9	1.8	-4.1	4.5
Poland	-3.0	3.0	13.9	67.1	23.6	2.1	-4.5	4.4
Slovenia	-1.8	0.9	19.4	34.0	NA	4.3	-1.7	4.0

Note: Countries are ordered according to their CA/GDP ratio. CA, net FDI and budget balance are in % of GDP and the rest are in percent (annual average for credit growth, inflation and GDP growth). Credit growth is nominal, GDP growth is real. Source: Eurostat, IMF, ECB.

financial strain as early as 2007. However the situation changed dramatically in mid-September 2008. In most new member states foreign currency financing dried up, domestic interbank money markets stumbled, bond spreads and credit default swaps on government debt deteriorated sharply, and currencies came under pressure (Figures 1 and 2).

The deterioration was sharp enough to necessitate strong and immediate policy responses: in October, Hungary entered into an IMF-led agreement and Latvia also started discussions with the Fund.

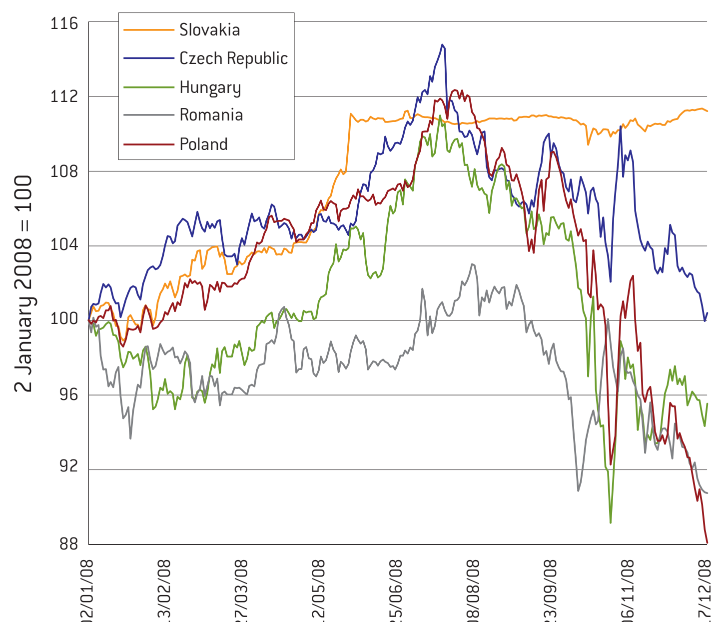
2. CHANNELS OF TRANSMISSION

Through which channels was the crisis transmitted to the non euro-area new member states? And to what extent did the European framework and the way the crisis was managed in the euro area mitigate or amplify the crisis in the non euro-area new member states?

Mitigating factors

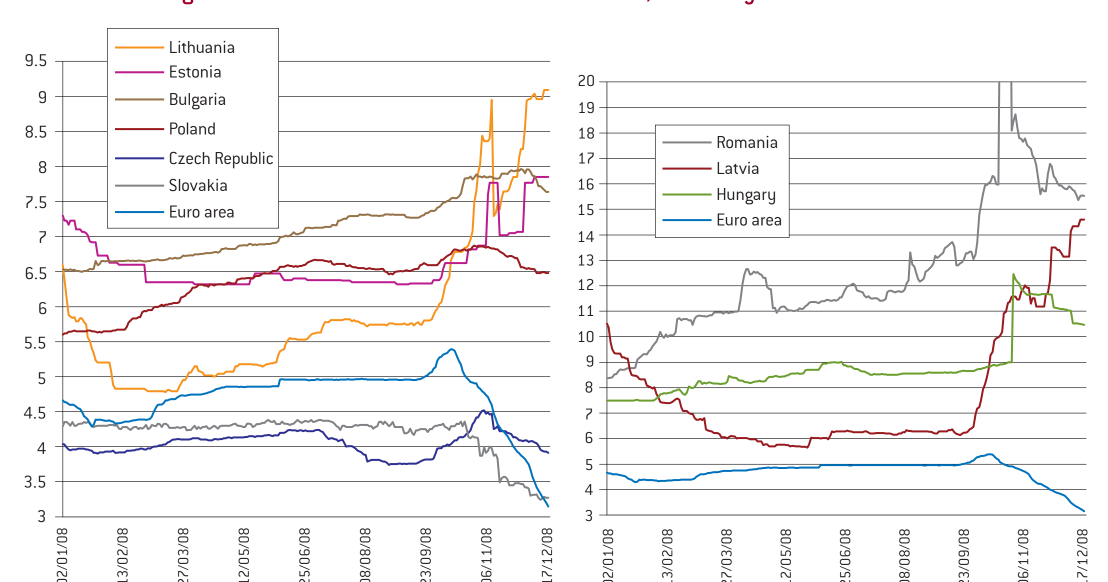
EU membership. EU membership has certainly served to strengthen the new member states. It has helped to make policy institutions in the new member states stronger, has enhanced their credibility and symbolises the irreversible character of integration between the formerly separate parts of Europe.

Figure 1:
Nominal exchange rates against the euro, 2 January - 17 December 2008



Note: an increase in the index indicates appreciation against the euro. Source: ECB.

Figure 2: 3-month interbank offered interest rates, 2 January - 17 December 2008



Note: the Romanian rate peaked at 49.81 percent on 20 October 2008, but for better readability of the right-hand panel the vertical axis has a 20 percent cut-off. Source: Datastream.

Foreign ownership of banks in the new member states. About 70 percent of the banks in central and eastern Europe are owned by western European banks; in some countries their share is even close to 100 percent (Table 1). The commitment not to let any systemically important bank fail in the euro area also helped their subsidiaries in the new member states. Without western ownership banks in the region would probably have been denied euro liquidity altogether.

EU participation in multilateral crisis lending. Hungary has agreed a €20 billion financing package from the IMF, EU and the World Bank. The larger-than-expected package and the participation of the EU alongside the two international organisations signal international determination to combat contagion of the financial crisis from one country to the other.

Repurchase agreements between the ECB and central banks. A facility introduced by the ECB on 16 October 2008 (for Hungary) and 21 November 2008 (for Poland) helped Hungarian and Polish commercial banks to roll over through their central banks their existing swaps that they had previously rolled over with euro-area commercial banks.

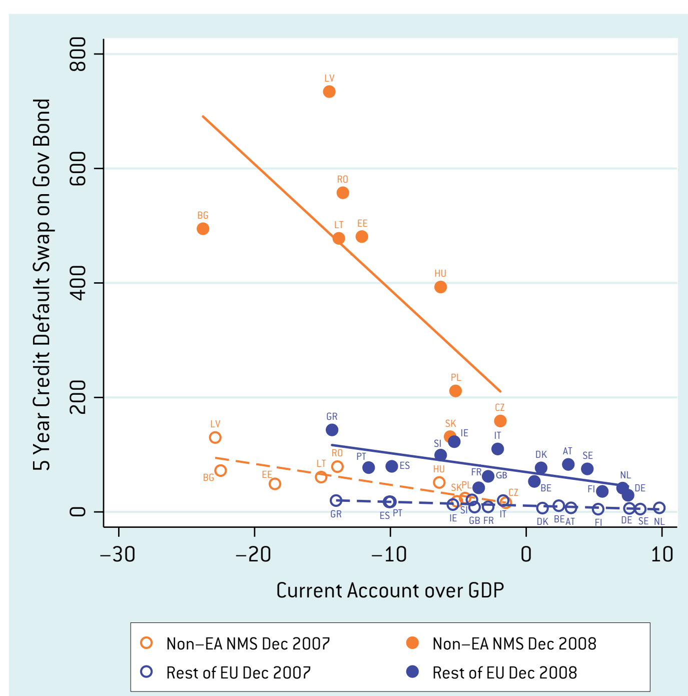
Amplifying factors

Flight to quality. The flight to quality, typically into US and German government securities and bank deposits, reflecting the credibility of institutions and guarantees, affected most emerging countries and even some euro-area members. But country-specific vulnerabilities did play a role, as indicated by the correlation between the cost of credit default swaps (CDS) and current account deficits (Figure 3). While this correlation was present before the crisis, the relationship has recently become starker.

Uncoordinated sequence of deposit guarantee upgrades. Starting in September 2008 euro-area governments substantially increased their deposit guarantees (some are unlimited), though this was initially done in an uncoordinated fashion. Later on, joint decisions were made and governments in the new member states also introduced such measures. But the uncoordinated sequence of deposit guarantees in the EU may have compounded the effects of uneven credibility and flight to quality.

Asymmetric liquidity and credit management. In times of stress liquidity management and credit distribution decisions are not only driven by long-term profit maximisation. While western European parent banks did provide continued access to liquidity for subsidiaries, anecdotal evidence suggests that in periods of heightened stress some of them have prioritised hoarding liquidity at home. Banks may also curtail credit asymmetrically in the future. This

Figure 3:
Cost of insurance against government default and the current account



Note: A credit default swap (CDS) is a credit derivative contract between two counterparties. The buyer makes periodic payments to the seller, and in return receives a payoff if the underlying financial instrument defaults. CDS values for December 2008 refer to the average of the first two weeks of this month. Annual values are shown for the current account; 2008 values are forecasts by the DG ECFIN of the EC. CDS data are not available for Cyprus, Malta and Luxembourg. Source: Authors' calculation using data from Datastream and the DG ECFIN of the EC.

could either be a rational response to deteriorating economic conditions in the new member states, or a result of commitments to maintain or increase credit in the home country as a counterpart to public recapitalisation.

Restricted access to euro liquidity. The near-paralysis of the euro-area interbank money market implies that (especially non foreign-bank owned) commercial banks in the new member states were largely cut off from euro liquidity. Domestic central banks could have provided euro liquidity through drawing on their foreign currency reserves, but in times of crisis, this is not deemed sensible.

Currency denomination of government bonds. The list of securities eligible for ECB refinancing does not include local currency-denominated bonds issued by the governments of the non euro-area new member states. While this was a perfectly natural provision when the European money markets worked smoothly, the liquidity shortage has made it unattractive for euro-area financial institutions to hold non-euro government bonds, thus contributing to their sell-off.

Trade and FDI. The economies of the new member states are heavily dependent on trade with the EU. With the recession in the euro area, exports from the new member states will be hit hard. This factor is primarily of relevance in the medium term but it may matter for the current reassessment of the region's prospects.

Slow policy response in some new member states. Last but not least, not all new member states have introduced appropriate measures to alleviate the effects of the crisis. Both government (where the budget allows) and central banks could have done more to dampen the effects of the crisis.

3. IS SOMEONE TO BLAME?

Spill-over effects are one thing, assigning responsibility is another. Can euro-area countries or the EU be blamed for having contributed to the crisis in the new member states? Or should governments in the new member states themselves be blamed for having pursued past policies which led to severe vulnerabilities and for having made inappropriate policy choices during the current crisis?

For some of the channels of transmission of the crisis there is little that governments, central banks and supervisors in the euro area could have done to mitigate their effects. This applies especially to the steep rise in risk aversion and the weaker perceived credibility of the new member states. However, other action - or inaction – decided upon in the heat of the crisis may have had unintended consequences. For example, the more the ECB was (rightly) moving into new territory to remedy the shortage of liquidity in the euro area, the more it was inadvertently putting new member states' banks – at least those without access to a parent bank's liquidity – at disadvantage. The same logic applies to the uncoordinated introduction of deposit guarantees.

But the new member states bear some of the blame themselves. There was widespread complacency about extremely large current-account deficits and inaction in the face of property booms. In the case of Hungary, earlier fiscal profligacy also played a role. These factors all contributed to the vulnerability of the new member states' economies.

However, beyond individual finger-pointing we would like to emphasise that one of the major lessons of the current crisis is that it highlights significant shortcomings in Europe's existing institutional architecture

Financial integration

The financial systems of the new member states have become closely integrated with those of the euro-area countries (Table 1).

We argued in Section 2 that western European ownership of new member states' banks had both positive and negative effects when the crisis hit. It also had a role in the pervasive development of foreign-currency loans to the private sector that characterises many countries in the region and which are a well-documented source of vulnerability.

The development of foreign-currency financing has in fact resulted from supply and demand factors. On the supply side, spreads between credit rates and money-market rates made it a lucrative business for banks, which in part explains why subsidiaries of western banks in the new member states were highly profitable. On the demand side, high inflation and consequently high nominal interest rates in some member countries made foreign-currency borrowing attractive. Since the real exchange rate of new member states' currencies was expected to appreciate as a consequence of catching up, it was rational for those households and corporations that could manage any short-term exchange-rate fluctuations to take on foreign currency loans.

Looking ahead, a lesson from the crisis is that foreign-currency borrowing is a side-effect of financial integration that involves significant risks. Provided it is done in a non-discriminatory way, limiting the risks by containing such borrowing can be regarded as a legitimate policy objective.

Euro-area enlargement

Ten of the 12 new member states could by now have joined the euro area, had they met the admission criteria[1]. In fact, by January 2009, four of them will indeed be part of the euro area. Some of the others – Poland for example – have made the deliberate choice to postpone membership. Others were rejected (Lithuania) or discouraged from applying, and the EU can certainly be criticised for clinging to criteria ill-suited to catching-up countries (Pisani-Ferry *et al* 2008, Darvas and Szapáry 2008). Generally, neither euro-area governments nor European institutions expressed a wish for speedy euro-area enlargement. So the blame, if any, for slow euro-area enlargement must be shared.

External stability concerns would suggest early euro-area entry: being inside a large currency area helps considerably for small open economies in times of crisis. But the experience of the Czech Republic and Slovakia, two countries that have both maintained macroeconomic stability, shows that such concerns are primarily relevant for countries that have accumulated domestic vulnerabilities.

As for long-term growth and macroeconomic management, the crisis has also provided a new perspective.

On the one hand, if the operation of financial markets and capital flows normalises in the near future, then the argument that speedy euro-area enlargement may not be in the best interests of fast-moving catch-up economies will prevail (Darvas and Szapary 2008). Entering the euro area while the price catch-up is still far from complete may result in an excessively low real interest rate, which may in turn favour excess investment in property or unproductive capital. A severe adjustment crisis is possible within the euro area, too, as indicated by the case of Ireland and Spain (Ahearne *et al*, 2008) and Portugal.

On the other hand, for countries not in the euro area, the crisis has called into question the sustainability of relying excessively on capital inflows. The risk that these inflows will diminish in the foreseeable future has increased substantially. Countries whose domestic investment is heavily financed by capital inflows will hence face the dilemma of either staying out of the euro area and risking low growth, or entering the euro area and facing the risk of boom and bust cycles. There is no clear-cut and one-size-fits-all solution to this dilemma.

A special case applies to those countries in fixed exchange-rate systems. These countries are caught in a trap now. Given the large share of foreign-currency lending, an abandonment of the peg followed by sharp depreciation would have a devastating effect. However, under a fixed exchange rate the reduction in current account deficits made necessary by the reversal of private capital flows will probably imply severe recession, unless domestic prices and wages are sufficiently flexible. This macroeconomic dilemma is bound to dominate policy choices. It would not be solved by early entry into the euro area.

European surveillance

Finally, the current crisis highlights the shortcomings of the European surveillance system. EU institutions anticipated that, at some point, countries which had accumulated serious vulnerabilities would face severe adjustments and they did express concern, but the institutional framework failed to deliver strong enough warnings to prompt timely remedial action. When the crisis hit, it was the IMF which had to play the key role in the design and financing of the rescue packages.

4. RECOMMENDATIONS

We first suggest that the following action should be taken as soon as possible.

1. **Swap agreements.** The ECB should introduce temporary reciprocal currency arrangements (swap lines, Box 1) with

[1] This claim is not valid for Bulgaria and Romania, which joined the EU in 2007.

central banks of the new member states to provide them with euro liquidity against their own currencies, as it did for the Danish central bank (on 27 October 2008) and as the US Fed did for 14 central banks.

2. **Wider collateral.** The ECB should temporarily accept as eligible securities for its repurchase transactions with counterparties government bonds issued not only in euros, but also in the domestic currencies of new member states. This move would be an extension of the ECB's recent decision to accept low-quality securities as collateral. The ECB should not take exchange-rate risk, hence it should apply an appropriate haircut to non-euro sovereign bonds to cover that risk. This initiative would eliminate the current strong incentive for euro-area banks not to hold in their portfolios domestic currency-denominated government bonds of new member states.

3. **Avoidance of asymmetric credit constraints.** Western European governments and supervisors should avoid measures that would risk causing western-owned banks in the new member states to curtail credit beyond what is justified by economic and financial developments in the relevant market.

4. **Policy action within the new member states.** Central banks and governments in the new member states should prevent credit contraction and provide a fiscal boost where budgets allow.

Whereas the above initiatives would address the immediate risks, more permanent responses should also be discussed and implemented. These are in particular:

1. **More effective surveillance.** EU surveillance should be strengthen with a view to fostering early diagnosis of vulnerabilities and remedial action.

2. **Level playing field.** The enforcement of the EU single market and competition rules is of major importance in maintaining the integrity of the European single market. Governments should avoid subsidies or moral suasion which may distort trade or discourage foreign direct investments in the new member states.

3. **European financial supervision.** The asymmetry in bank ownership highlighted by the crisis further underlines the need for EU-wide supervision of banks with significant cross-border activities, as already suggested for other reasons (Véron, 2007).

4. **EU-wide coordination of guarantees.** A permanent mechanism should be established to ensure coordination of bank deposit guarantees in the EU and to avoid an unfair advantage accruing to early movers.

BOX 1: CURRENCY SWAPS BETWEEN CENTRAL BANKS VERSUS ERM-II FACILITIES AND BALANCE-OF-PAYMENTS ASSISTANCE

A *currency swap* is a foreign-exchange agreement between two parties to exchange a given amount of one currency for a given amount of another and, after a specified period of time, to give back the original amounts swapped. Each party remains responsible for its own assets and liabilities and hence none of them are exposed to foreign-exchange risk.

Such an arrangement between the ECB and a national central bank would not entail a default risk for the ECB unless one attaches a non-zero probability of a foreign-exchange payment default. The arrangement would temporarily help a national central bank to provide euro liquidity to its banking system without drawing on its reserves.

Currency swaps should not be confused with the already existing short-term financing facility available for ERM-II participants to support the stability of the exchange rate.

Currency swaps should also not be confused with the already existing longer-term *balance-of-payments assistance* to a country to help it to rebuild foreign-exchange reserves. The EU has a medium-term financial assistance facility for non euro-area member states, established in 2002 with a limit that was raised to €25 billion on 25 November 2008.

5. **EBRD and EIB financing.** The EBRD and EIB should increase their financing to the non euro-area new member states in recognition of the shortcomings in European financial integration evident in times of crisis.

6. **Real exchange-rate adjustment.** Countries that operated fixed exchange-rate systems and accumulated huge foreign-currency liabilities may not need to introduce a floating exchange-rate regime because of the possibility of severe overshooting in exchange-rate depreciation, but should find other means to facilitate real exchange-rate adjustment. Where feasible, a social consensus to cut nominal wages would be less painful than other available options.

5. CONCLUSION

Four important broader issues emerge from our analysis.

First, when the crisis intensified, the euro area understandably gave priority to coordinating decisions among the participant countries and with the ECB. But the euro area institutions now need to recognise that the consequences of their actions are not confined to the boundaries of the euro area and take their broader effects into account when taking decisions.

Second, the current crisis has fundamentally called into question, for countries not in the euro area, the growth model that relied on substantial capital inflows. This new context calls for policy adjustments in the new member states, but also for EU responses to foster continued financial integration and a resumption of capital flows. Avoidance of any measure tending towards market fragmentation is of utmost importance.

Third, the debate over euro-area enlargement needs to be seen in a new light. But it has not become any simpler. Although previous arguments against early adoption given the risk of creating boom-bust cycles remain valid, the attractiveness of joining the euro area has increased substantially for countries that rely heavily on capital inflows. At the same, however, those same countries may need an adjustment in their real exchange rate in order to bring about a reduction in their current-account deficits.

Finally, a crisis is a defining moment that shapes future attitudes. It is too early to say what lessons will be drawn from the current crisis but they will certainly have lasting consequences. While the responsibility for the current problems does all not lie on one side, the perception has developed in some new member states that solidarity is in short supply when crisis strikes. To correct this perception, individual governments and the EU need to discuss the contentious issues openly and ensure that they draw common, rather than divergent, conclusions. If they do this, we may avoid creating a new divide within Europe.

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